56513 40pgs

14

No. 06-1413

Supreme Court, U.S.
FILED
DEC 10 2007
OFFICE OF THE CLERK

In The Supreme Court of the United States

MEADWESTVACO CORPORATION, successor in interest to THE MEAD CORPORATION,

Petitioner,

v.

ILLINOIS DEPARTMENT OF REVENUE, DIRECTOR OF THE ILLINOIS DEPARTMENT OF REVENUE, AND TREASURER OF THE STATE OF ILLINOIS,

Respondents.

On Writ Of Certiorari To The Appellate Court Of Illinois

BRIEF OF THE STATES OF CALIFORNIA, ARKANSAS, CONNECTICUT, FLORIDA, IDAHO, INDIANA, IOWA, KANSAS, MAINE, MARYLAND, MICHIGAN, MINNESOTA, MISSOURI, NEVADA, NEW HAMPSHIRE, NORTH DAKOTA, OKLAHOMA, OREGON, PENNSYLVANIA, SOUTH CAROLINA, TENNESSEE, UTAH, VERMONT, AND WEST VIRGINIA, AND THE COMMONWEALTH OF PUERTO RICO AS AMICI CURIAE IN SUPPORT OF RESPONDENTS

EDMUND G. BROWN JR.
Attorney General of the
State of California
MANUEL M. MEDEIROS
State Solicitor General
DAVID CHANEY
Chief Assistant Attorney General
PAUL GIFFORD
Senior Assistant Attorney General
GORDON BURNS
Deputy Solicitor General
ANNE MICHELLE BURR
Deputy Attorney General
GEORGE SPANOS
Deputy Attorney General
Counsel of Record
1300 I Street
Sacramento, California 94244-2550
Telephone: (916) 324-7862
Fax: (916) 327-2247
Counsel for Amici Curiae

[Additional Counsel Listed On Inside Cover]

COCKLE LAW BRIEF PRINTING CO (800) 225-6964
OR CALL COLLECT (402) 342-2831

DUSTIN MCDANIEL
Attorney General of Arkansas
323 Center Street, Suite 200
Little Rock, Arkansas
72201-2610

RICHARD BLUMENTHAL
Attorney General
of Connecticut
OFFICE OF THE
ATTORNEY GENERAL
55 Elm Street
Hartford, Connecticut 06106

BILL MCCOLLUM
Attorney General of Florida
OFFICE OF THE
ATTORNEY GENERAL
The Capitol, PL-01
Tallahassee, Florida
32399-1050

LAWRENCE G. WASDEN
Attorney General of Idaho
P.O. Box 83720
Boise, Idaho 83720-0010

STEVE CARTER
Attorney General of Indiana
302 West Washington Street
IGC South – Fifth Floor
Indianapolis, Indiana 46204

THOMAS J. MILLER
Attorney General of Iowa
1305 E. Walnut Street
Des Moines, Iowa 50319

PAUL J. MORRISON
Attorney General of Kansas
OFFICE OF THE
ATTORNEY GENERAL
120 SW 10th Avenue,
Room 200
Topeka, Kansas 66612

G. STEVEN ROWE
Attorney General of Maine
6 State House Station
Augusta, Maine 04333-0006

DOUGLAS F. GANSLER
Attorney General
of Maryland
200 Saint Paul Place
Baltimore, Maryland 21202

MICHAEL A. COX
Attorney General
of Michigan
P.O. Box 30212
Lansing, Michigan 48909

LORI SWANSON
Attorney General
of Minnesota
102 State Capitol
75 Rev. Dr. Martin Luther
King, Jr. Blvd.
St. Paul, Minnesota
55155-1609

JEREMIAH W. (JAY) NIXON
Attorney General of Missouri
Supreme Court Building
P.O. Box 899
Jefferson City, Missouri
65102-0899

CATHERINE CORTEZ MASTO
Attorney General of Nevada
100 North Carson Street
Carson City, Nevada 89701

KELLY A. AYOTTE
Attorney General
of New Hampshire
33 Capitol Street
Concord, New Hampshire
03301

WAYNE STENEHJEM
Attorney General
of North Dakota
600 E. Boulevard Avenue
Bismarck, North Dakota
58505-0040

W.A. DREW EDMONDSON
Attorney General of Oklahoma
313 N.E. 21st Street
Oklahoma City, Oklahoma
73105-4894

HARDY MYERS
Attorney General of Oregon
1162 Court St. N.E.
Salem, Oregon 97301

THOMAS W. CORBETT, JR.
Attorney General
of Pennsylvania
16th Floor, Strawberry Square
Harrisburg, Pennsylvania
17120

HENRY MCMASTER
Attorney General
of South Carolina
P.O. Box 11549
Columbia, South Carolina
29211-1549

ROBERT E. COOPER, JR.
Attorney General
of Tennessee
STATE OF TENNESSEE
P.O. Box 20207
Nashville, Tennessee
37202-0207

MARK L. SHURTLEFF
Attorney General of Utah
Utah State Capitol Complex
East Office Bldg., Suite 320
Salt Lake City, Utah
84114-2320

WILLIAM H. SORRELL
Attorney General of Vermont
109 State Street
Montpelier, Vermont
05609-1001

DARRELL V. MCGRAW, JR.
Attorney General
of West Virginia
OFFICE OF THE ATTORNEY
GENERAL
State Capitol, Room 26-E
Charleston, West Virginia
25305

ROBERTO J. SANCHEZ-RAMOS
Secretary of Justice
Commonwealth of
Puerto Rico
P.O. Box 9020192
San Juan, Puerto Rico
00902-0192

QUESTION PRESENTED

Whether the Court should adopt a set of rigid standards to replace the flexible test described in *Allied Signal v. Director*, 504 U.S. 768 (1992) for determining whether States may apportion corporate income under the Due Process and Commerce Clauses?

TABLE OF CONTENTS

Page

INTEREST OF AMICI CURIAE 1

SUMMARY OF ARGUMENT 2

ARGUMENT 6

I. State Apportionment Of Income Is Proper If There Are Sufficient Connections Between The Income To Be Taxed And The State Imposing The Tax 6

II. The Existence Of Either A Unitary Relationship Or An Operational Function Or Purpose Supports A Determination Of Apportionability Under The Unitary Business Principle 9

A. For Purposes Of Apportionment Of Income, The Unitary Business Principle Views As A Single Enterprise Those Components Of A Multistate Business That Are Minimally Connected And That Are Rationally Related To The Taxpayer's Activities In The Taxing State 9

B. The Existence Of A "Unitary Relationship" Among Subsidiaries Or Divisions Satisfies The Constitutional Standard For Apportionment 10

TABLE OF CONTENTS – Continued

Page

C. The Constitutional Standard Is Also Satisfied When An Asset Serves An Operational Function Or Purpose For The Taxpayer's Multistate Business 11

D. By Contrast, An Asset Of Any Kind Which Is Not Linked To The Taxpayer's Multistate Business Serves Only An Investment Function, And Income Derived From It Is Not Apportionable 13

III. Mead's Argument Fundamentally Misconceives The Operational Function Concept And Would Limit Its Utility 14

A. The "Unitary Business Principle" Is Not The Same Thing As A "Unitary Relationship" 15

B. An Operational Function Is Not A "Narrow Exception" To The Unitary Business Principle 16

C. The Factors That Support A Determination That A Unitary Relationship Exists May Also Support The Existence Of An Operational Function 18

D. Mead's Argument That This Court Should Adopt A Standard That Exceeds This Court's Articulation Of The Constitutional Standard For The Apportionment Of Income Should Be Rejected 21

TABLE OF CONTENTS – Continued

Page

E. Mead's Suggestion That Certain Factors Can Never Support Apportionment Should Be Rejected; The Relevance Of Particular Kinds Of Evidence Must Be Determined By The Trier Of Fact On A Case-by-Case Basis 22

IV. The Court Should Reject Mead's Implied Suggestion That The Burden Of Proof Should Be Shifted To The Tax Agency 28

V. Illinois Properly Determined That The Income Was Apportionable 30

CONCLUSION 32

TABLE OF AUTHORITIES

Page

CASES

Allied Signal v. Director, Division of Taxation, 504 U.S. 768 (1992) ..... *passim*

ASARCO, Inc. v. Idaho State Tax Comm'n, 458 U.S. 307 (1982) 11

Barclays Bank PLC v. Franchise Tax Bd., 512 U.S. 298 (1994) 10

Container Corporation of America v. Franchise Tax Board, 463 U.S. 159 (1983) ..... *passim*

Exxon Corp. v. Department of Revenue of Wisconsin, 447 U.S. 207 (1980) 10, 11

F.W. Woolworth Co. v. Taxation & Revenue Department of the State of New Mexico, 458 U.S. 354 (1982) 11

Hoechst Celanese Corporation v. Franchise Tax Board, 22 P.3d 324 (Cal. 2001) 1

Magee v. United States, 282 U.S. 432 (1931) 25

Mead Corp. v. Department of Revenue, 371 Ill. App. 3d 108 (2007) 23

Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425 (1980) 10, 11, 17, 23

Norton Co. v. Department of Revenue, 340 U.S. 534 (1951) 28

Stearns Co. v. United States, 291 U.S. 54 (1934) 25

INTEREST OF AMICI CURIAE

Every State has an interest in how the Supreme Court resolves the issues presented in the instant case. As the California Supreme Court put it not long ago, "[s]tates have long struggled to devise an equitable and constitutional method for taxing corporations that do business in multiple states and countries." *Hoechst Celanese Corporation v. Franchise Tax Board*, 22 P.3d 324, 328 (Cal. 2001). In the process, all States have attempted to fashion ways to determine the amount of a multistate enterprise's income that may properly be taxed by the State, while at the same time acknowledging that there are limits that must be recognized. For the last 15 years States have been guided in this effort by this Court's decision in *Allied Signal v. Director*, 504 U.S. 768 (1992) and have developed a settled body of law based on that case.

Amici share with Illinois a common respect for the limits upon state income taxation which arise from the Due Process and Commerce Clauses of the Constitution. Amici urge this Court to reaffirm its previous articulation of the constitutional standard for such taxation, and not to adopt the narrower constraints on state apportionment of the multistate income of a multistate business proposed by petitioner.

SUMMARY OF ARGUMENT

The amici States ask the Court to continue the traditional, flexible approach to apportionment that this Court most recently affirmed in *Allied Signal v. Director, Division of Taxation*, 504 U.S. 768 (1992) ("*Allied Signal*") and reject Mead's attempt to replace it with two rigidly delineated tests.

States have applied *Allied Signal* for fifteen years without undue difficulty or controversy. Under the Due Process and Commerce Clauses, a State may not tax income that a corporation generated outside its borders. It may, however, tax income when there is a "minimal connection" and a "rational relation" between the State and the income. The touchstone for these constitutional limits is the unitary business principle. Under this principle, the various activities of a business may be viewed as a single enterprise – thus establishing the requisite connection between a State and the business' income-generating components – when value flows between the components. Unlike income, flows of value can be subtle and difficult to quantify. Thus, in the case of a taxpayer that manufacturers a product in one State and sells it in another, there is a relationship between each of the two States and each of the company's two activities that meets the constitutional standard. Likewise, the requisite connection exists when a rail line that passes through one State makes possible the operation of a railroad connecting commercial centers located in other States.

Although Mead concedes "that this Court's test works in practice and that adoption of any new rule will disturb settled expectations upon which States and corporations rely," (Pet. Brief, pp. 48-49), it attempts to redefine the existing, flexible standard as two rigid, mutually exclusive tests, which it calls the unitary business principle and the operational function test. There are several problems with Mead's approach.

First, Mead is confusing three distinct concepts. There is just one test which determines whether there is a flow of value between the relevant income-generating components of a corporation: whether there exist the required minimal connection and rational relation. Mead confuses this test with two scenarios in which the test has been applied. One scenario describes a *unitary business relationship*, in which various income-generating business are sufficiently connected through transfers or flows of value to be viewed as a single enterprise for tax apportionment purposes. A second scenario describes an *operational function*, in which an asset supports the corporation's multistate operations. These two concepts are not themselves constitutional tests; rather, they are applications of the unitary business principle to different factual circumstances. In each instance, the constitutional standard is met because value flows between a corporation's various businesses (unitary relationship) or between an asset and the taxpayer's multistate business activities (operational

function), and thus the minimal connections and rational relations exist.

In addition to misconstruing the unitary business principle, Mead attempts to narrow the standard in various ways. It suggests that operational functions and unitary relationships are mutually exclusive concepts. In fact, in the diverse world of business, the factors that indicate one or the other may well overlap. Indeed, this Court has resisted a rigid approach to the issue because "any number of variations on the unitary business theme 'are logically consistent with the underlying principles motivating the approach.'" *Allied Signal*, 504 U.S. at 785, quoting *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159, 167 (1983) ("*Container*"). Likewise, using the facts of this single case, Mead effectively would have the Court deem irrelevant entire categories of evidence in future cases. The Court has prudently resisted prescribing rigid formulae for lower courts to use when applying the unitary business principle, noting that "the constitutional test is quite fact sensitive," *id.*, and it should continue to do so.

Amici States are also concerned that Mead is attempting to undermine the burden of proof. By arguing that the State has failed to satisfy the constitutional minimum, Mead obliquely suggests that the State bears the burden on the issue. It is well-settled, however, that the taxpayer "has the burden of proof; it must demonstrate that there is 'no rational relationship between the income attributed to the State and the intrastate values of the enterprise.'"

Container, 463 U.S. at 180. Clarity on this issue is crucial for the States. The taxpayers, after all, control the records, data, and other information that reveal the nature of their often-complex businesses.

Here, Mead has failed to meet its burden. Under the unitary business principle, the ultimate question is whether Mead has demonstrated that there was no flow of value between Lexis and Mead's multistate business. Mead manipulated its corporate structure when it merged Lexis into Mead for the purpose of setting off against the gains of one part of the business the losses incurred by another part, with the result that Mead expected an ongoing savings in its state income tax burden caused by the reduction in the amount of its apportionable income that would have been taxed. The decrease in that tax burden would have caused an increase in Mead's net after-tax apportionable income. Consequently, there is evidence of a flow of value between Lexis and Mead's multistate business sufficient to establish the minimal connections and rational relation required by the Constitution.

ARGUMENT

I. State Apportionment Of Income Is Proper If There Are Sufficient Connections Between The Income To Be Taxed And The State Imposing The Tax

In its decision in *Allied Signal*, based on its review of earlier precedent, this Court noted that a State's imposition of tax on an apportioned share of a multistate business' income is subject to the Due Process and Commerce Clauses of the Constitution. These clauses require that there be "some definite link, some minimum connection, between a State and the person, property or transaction it seeks to tax." *Allied Signal*, 504 U.S. at 777. A single State may tax the multistate income of a nondomiciliary corporation if there is a "minimal connection" between the interstate activities and the taxing State, and if there is "a rational relation between the income attributed to the taxing State and the intrastate value of the corporate business." *Id.* at 772.

This Court's precedents make it clear that the determination concerning the existence of sufficient connections and rational relations does not involve the application of formalized rules. As this Court put it in *Allied Signal*, "modern due process jurisprudence rejects a rigid, formalistic definition of minimum connection." *Id.* at 778.

The sufficient connections and rational relations are satisfied by the unitary business principle. It is a

principle which takes into account the transfers of value which can occur among the components of an interstate business enterprise when they function together. *Id.* at 783.

The unitary business principle has its roots in Nineteenth Century cases involving the application of property taxes to property owned by railroads and telegraph companies:

> When States attempted to value railroad or telegraph companies for property tax purposes, they encountered the difficulty that what makes such a business valuable is the enterprise as a whole, rather than the track or wires that happen to be located within a State's borders. The Court held that, consistent with the Due Process Clause, a State could base its tax assessments upon 'the proportionate part of the value resulting from the combination of the means by which the business was carried on, a value existing to an appreciable extent throughout the entire domain of operation.'

Allied Signal, 504 U.S. at 778-779, quoting from an 1897 opinion. Thus, the various physical components were considered in the aggregate in assessing their value. The rail passing over the distant prairies and through the uninhabited deserts had a value which took into account the fact that it linked the great commercial centers of the East and Midwest with the growing population centers of the West Coast. Later, this concept of physical unity was applied to other

sorts of unity, and eventually the unitary business principle was applied to the taxation of corporate income. *Id.*

Given its history, it is not surprising that this Court recognizes the principle's flexibility. "[T]he unitary business principle is not so inflexible that as new methods of finance and new forms of business evolve it cannot be modified or supplemented where appropriate." *Id.* at 786. The unitary business principle is "workable in practice" because it is not rigid or formalistic. *Id.* at 785.

> If lower courts have reached divergent results in applying the unitary business principle to different factual circumstances, that is because, as we have said, any number of variations on the unitary business theme 'are logically consistent with the underlying principles motivating the approach.'

Id. at 785, quoting from *Container*. Likewise, this Court has recognized that the constitutional test is very "fact sensitive." *Id.*

II. The Existence Of Either A Unitary Relationship Or An Operational Function Or Purpose Supports A Determination Of Apportionability Under The Unitary Business Principle

A. For Purposes Of Apportionment Of Income, The Unitary Business Principle Views As A Single Enterprise Those Components Of A Multistate Business That Are Minimally Connected And That Are Rationally Related To The Taxpayer's Activities In The Taxing State

Under the unitary business principle, the various components of a business enterprise can be viewed as a single enterprise when value flows or is transferred between the components. *Allied Signal*, 504 U.S. at 783; *Container*, 463 U.S. at 164-165. That is, the principle considers these components to constitute a "unitary business." On that basis, the Constitution allows the income of the unitary business to be apportioned.

> The 'linchpin of apportionability' for state income taxation of an interstate enterprise is the 'unitary business principle.' [Citations deleted.] If a company is a unitary business, then a State may apply an apportionment formula to the taxpayer's total income in order to obtain a 'rough approximation' of the corporate income that is 'reasonably related to the activities conducted within the taxing State.'

Exxon Corp. v. Department of Revenue of Wisconsin, 447 U.S. 207, 223 (1980). The principle applies whether the business enterprise is a single corporate entity or whether it involves several commonly owned corporations. *Container*, 463 U.S. at 164-165; *Barclays Bank PLC v. Franchise Tax Bd.*, 512 U.S. 298 (1994).

A transfer or flow of value is not the same thing as income. Income is quantifiable. However, as this Court has noted, a flow or transfer of value among components of a business can be "subtle and largely unquantifiable." *Container*, 463 U.S. at 164-165. The rail linking the various commercial centers served by a railroad contributes value because it makes possible the generation of income. This is true even though the rail itself is not a source of income and does not produce quantifiable income. In the case of a multi-jurisdictional business which manufacturers its product in one state and sells it in another, the income may arise in just the second state, but the manufacturing in the first state obviously contributed to the value of the company's interstate business. *See, e.g.*, discussion in *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 438-439 (1980).

B. The Existence Of A "Unitary Relationship" Among Subsidiaries Or Divisions Satisfies The Constitutional Standard For Apportionment

The phrase "unitary relationship" typically is used to refer to the relationship between a taxpayer

and its subsidiaries, or between a taxpayer and its divisions. Most of this Court's recent decisions concerning apportionment of business income have involved such relationships. *See, e.g., Exxon Corp., supra*; *F.W. Woolworth Co. v. Taxation & Revenue Department of the State of New Mexico*, 458 U.S. 354 (1982) ("*Woolworth*"); *Mobil Oil, supra*, and *ASARCO, Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307 (1982) ("*ASARCO*"). To conclude that such a relationship exists is to conclude that there exist the minimal connections and rational relationship required by the Constitution. In any event, Mead does not dispute that a "unitary relationship" is a basis for apportioning income.

C. The Constitutional Standard Is Also Satisfied When An Asset Serves An Operational Function Or Purpose For The Taxpayer's Multistate Business

This Court also recognizes the fact that the unitary business principle applies, and justifies apportionment of income, when there exists an operational function between the taxpayer's business and the asset in question. This concept, like the unitary business principle itself, can be traced back to the railroad and telegraph cases mentioned above. The rail that links two commercial centers makes possible the commercial exchanges that occur between them and thus adds value to the railroad which owns and operates its trains over that rail. That rail itself

constitutes an asset that serves an operational purpose or function.

Thus, the unitary business principle does not apply only to unitary relationships. As this Court stated in *Allied Signal*, commenting on earlier cases, "[w]e did not purport, however, to establish a general requirement that there be a unitary relation between the payor and the payee to justify apportionment, nor do we do so today." *Allied Signal*, 504 U.S. at 787. In the same portion of its opinion, this Court also noted that "[t]he existence of a unitary relation between payee and payor is one justification for apportionment, but not the only one." *Id.* Another justification is that the asset "serve an operational rather than an investment function." *Ibid.*, citing *Container*, 463 U.S. at 180, n. 19.

In determining whether an asset serves an operational function, the relevant inquiry should focus "on the objective characteristics of the asset's use and its relation to the taxpayer and its activities within the taxing State." *Allied Signal*, 504 U.S. at 785. This is the inquiry that must be pursued in order to determine if the constitutionally required minimal connections and rational relationship exist.

D. By Contrast, An Asset Of Any Kind Which Is Not Linked To The Taxpayer's Multistate Business Serves Only An Investment Function, And Income Derived From It Is Not Apportionable

Not all assets owned by a taxpayer engaged in a multistate business exhibit the minimal connections and rational relationship that would satisfy the constitutional standard. Those assets which do not satisfy the standard serve an investment function or purpose.

Assets that serve only an investment function can include not only physical assets, such as real property, or intangible assets such as stock, but also divisions and subsidiaries. Such assets may contribute income to the taxpayer. However, as this Court indicated in *Allied Signal*, the mere fact that an asset generates income for the taxpayer is not enough. *Allied Signal*, 504 U.S. at 784-785. If an asset does not contribute to the generation of *apportionable* income, the constitutional standard is not satisfied. There is no minimal connection or rational connection, there is no flow of value between the asset and the multistate business, and hence there is neither a unitary relationship nor an operational function. Such an asset serves only an investment function. Any income derived from such an asset is allocated to one State (usually either the taxpayer's domicile or the situs of the asset as in the case of real property). Such income therefore is *not* apportioned.

In other words, the fact that an asset is somehow linked to the taxpayer, as through ownership, is not sufficient. The asset must be linked to the taxpayer's multistate business (*i.e.*, to that business activity which generates apportionable income) *in such a way* that the minimal connections and rational relationship exist.

III. Mead's Argument Fundamentally Misconceives The Operational Function Concept And Would Limit Its Utility

Although Mead appears to accept the concept of an operational function, its argument represents an effort to so limit its application as to eviscerate it. However, Mead's arguments are fundamentally flawed.

Mead's arguments are based on numerous misconceptions. Mead confuses the "unitary business principle" with the "unitary relationship," mistakenly characterizes what it calls the operational function test as a "narrow exception," and contends that evidence which is relevant to whether a unitary relationship exists cannot be relied upon in determining whether an asset serves an operational function. Mead also proposes a rule that would serve to prevent a trial court from considering what might very well be relevant evidence for purposes of determining apportionability. Through these means, Mead seeks

to isolate the concept of the operational function and to limit its application.

A. The "Unitary Business Principle" Is Not The Same Thing As A "Unitary Relationship"

Mead evidences confusion regarding the terms "unitary business principle," "operational function," and "unitary relationship." In numerous portions of its analysis, it refers to the "unitary business principle" and the "operational function test" as two parallel but discrete concepts. For example, at page 26 of its brief, Mead states, "The unitary business principle and the operational function test seek to capture the 'subtle and largely unquantifiable' in-State contributions to the overall value of a multi-state business." (Pet. Brief, p. 26; *see also*, pp. 27 and 44.)

By pairing "unitary business principle" with "operational function," Mead is treating the former as a synonym for "unitary relationship," and the latter as a concept separate and apart from "unitary business principle." This fact is confirmed by the following statement:

> Apportionment is permissible under the *unitary business principle* only where several businesses, as part of common ownership or as different parts of the same business, are so functionally dependent upon each other that the value of the whole is greater then [sic] the sum of its parts.

(Pet. Brief, p. 26; emphasis added.) In fact, what Mead is describing in the above quoted passage is a *unitary relationship.*[1]

Mead's confusion of these terms is not a mere curiosity. It affects and misdirects its analysis in general, as is demonstrated below.

B. An Operational Function Is Not A "Narrow Exception" To The Unitary Business Principle

Mead's misuse and confusion of the terminology has consequences for its analysis. It is part of the foundation for its erroneous assertion that operational function (or what it calls the operational function "test") is a "narrow exception" to the unitary business principle.

Mead appears to recognize that there are two avenues to determining whether income can be apportioned; one that is based on the existence of an operational function, and the other which it mistakenly

---

[1] Mead's reference to the value of the whole being "greater then [sic] the sum of its parts" is not supported by any cited authority. Although in many instances the aggregate value of a business enterprise may be enhanced by the unification of various elements, all that is required is a flow of value, not an enhancement of the type Mead suggests. Adoption of a rule that requires that the whole of a business enterprise exceed the value of the sum of its individual parts in order to establish a unitary relationship, or otherwise satisfy the unitary business principle, would cause enormous mischief.

refers to as the unitary business principle when it should be referring to the existence of a unitary relationship. It compounds that error by confusing what is meant by this Court when it refers to "the linchpin of apportionability."

This analytical flaw is vividly demonstrated in the following passage from Mead's brief:

> [T]his Court has repeatedly held that "the *linchpin* of apportionability in the field of state income taxation is the unitary-business principle." *Mobil Oil*, 445 U.S. at 439 (emphasis added). The operational function test, *by contrast*, constitutes a narrow *exception* that permits a State to tax an apportioned share of income or gain from an asset or investment that is not part of the unitary business. . . .

(Pet. Brief, pp. 25-26; second emphasis added.) In other words, Mead confuses "unitary business principle" with "unitary relationship." Having paired "unitary business principle" with "operational function test," Mead then incorrectly assumes that only one member of the pair, what it terms the "unitary business principle" but which is really "unitary relationship," is the "linchpin." Therefore, Mead erroneously concludes that the other member of the pair, the operational function "test," is a "narrow exception" that is not part of the unitary business principle.

In fact, the existence of an operational function is one of at least two ways in which the unitary

business principle can be applied. One other way is the unitary relationship approach. *See, e.g., Allied Signal*, 504 U.S. at 787. Neither is subordinate to the other, and neither is a "narrow exception" to the other. It is the unitary business principle that is the "linchpin," not the notion of a "unitary relationship."

C. The Factors That Support A Determination That A Unitary Relationship Exists May Also Support The Existence Of An Operational Function

Mead contends that only in limited circumstances can the Court find that an operational function exists. (Pet. Brief, p. 27.) Citing *Allied Signal*, Mead lists only two circumstances that would justify application of the operational function "test":

> where the asset is used to regularly fund the working capital of the unitary business that operates within the taxing State, or where the asset, itself, is designed to support the unitary business with the requisite nexus to the taxing State, such as by providing an ongoing stable supply of key resources.

(Pet. Brief, p. 30.) However, this Court prefaced this comment with the words "for example." *Allied Signal*, 504 U.S. at 787.

Mead's proposed bright line restriction on what may be considered in determining if an operational relationship exists should be rejected. It conflicts with this Court's description of the relevant constitutional

test. That test focuses on "the objective characteristics of the asset's use and its relation to the taxpayer and its activities within the taxing State." *Id.* at 785. It also conflicts with this Court's observation that the unitary business principle is flexible and can adapt as "new methods of finance and new forms of business" evolve. *Id.* at 786.

Mead contends that factors which might "inform" whether an asset is part of the taxpayer's unitary business, such as "oversight over and capital investment in the asset," and the description of the asset's business in the taxpayer's annual reports and Forms 10-K, "bear no relation to the operational function test." (Pet. Brief, pp. 17-18.) This contention is based in part on the premise that the two concepts, "unitary relationship" and "operational function," are mutually exclusive. That notion may be in harmony with Mead's view that operational function represents a "narrow exception." However, it conflicts with this Court's rejection of "a rigid, formalistic definition of minimum connection." *Allied Signal*, 504 U.S. at 778.

The fatal flaw in Mead's analysis goes back to its confusion between the terms "unitary business principle" and "unitary relationship." This flaw is revealed in the following statement: "[a] 'flow of value' between a taxpayer parent and its subsidiary or division is relevant to whether there is a unitary relationship and *not to whether the asset . . . served an operational function*, . . . " (Pet. Brief, p. 18; emphasis added.) Yet as this Court has pointed out,

> The principal virtue of the *unitary business principle* of taxation is that it does a better job of accounting for "the many subtle and largely unquantifiable *transfers of value* that take place among the components of a single enterprise" than, for example, geographical or transactional accounting.

Allied Signal, 504 U.S. at 783, quoting from *Container*; emphasis added.

The unitary business principle is an overarching principle that is based on transfers or flows of value. Both "operational functions" and "unitary relationships" are rooted in the essence of the constitutional test, that there be a minimal connection and a rational relationship linking the taxpayer's multi-state business to the asset giving rise to the income. *See Allied Signal*, 504 U.S. at 772. Both of them represent situations in which there is a flow of value between the one and the other. Although they represent "different variations on the theme," they are both "logically consistent with the underlying principles motivating the approach." *Container*, 463 U.S. at 167.

Indeed, as suggested by the foregoing language from *Container*, the concepts of "unitary relationships" and "operational function" are not mutually exclusive categories or concepts. Consequently, it would be a mistake to try to draw a bright line distinction between the two concepts and to endow them with "talismanic" properties. Likewise, it would be wrong to attempt to apply each of them without

reference to the underlying principle which supports both of them, and thus "[to] state[ ] a rule without [understanding] the reasons for it." *See Mobil Oil*, 445 U.S. at 445.

D. Mead's Argument That This Court Should Adopt A Standard That Exceeds This Court's Articulation Of The Constitutional Standard For The Apportionment Of Income Should Be Rejected

Mead contends that:

> This Court permits a State to tax an apportioned share of the gain or income from a nonunitary asset or investment under that [operational function] test only in circumstances where that asset provides a continuing, significant contribution to support the unitary business conducted in the State in some substantial, operational capacity.

(Pet. Brief, p. 29.) Elsewhere, Mead posits the requirement that the asset must provide "critical operational support" which must "sustain and support" the taxpayer's business. (Pet. Brief, pp. 3 and 17.) However, this Court's decisions do not support such characterizations. For example, the Constitution does not require that the asset play a "critical" role.

This Court has already explained what is required by the Due Process and Commerce Clauses. If minimum connections and rational relationships exist, the constitutional standard is satisfied. To the

extent Mead is urging this Court to articulate a new standard for the apportionment of income that exceeds the constitutional standard, its position should be rejected.

E. Mead's Suggestion That Certain Factors Can Never Support Apportionment Should Be Rejected; The Relevance Of Particular Kinds Of Evidence Must Be Determined By The Trier Of Fact On A Case-by-Case Basis

Mead further contends that:

> Illinois's narrow focus on factors that demonstrate no more than the existence of a corporate connection between Mead and Lexis/Nexis as a basis for taxing an apportioned share of Mead's gain from the sale of Lexis/Nexis cannot be squared with this Court's precedents.

(Pet. Brief. 46.) By so contending, Mead attempts to convert an evidentiary dispute into the basis for an absolute legal prohibition against the consideration of certain kinds of facts.

To one degree or another most of the factors cited by the Illinois appellate court can be relevant to a determination of apportionability.[2] No factor which is

---

[2] It is not clear that the Illinois appellate court considered "100 percent ownership" to be a factor supporting apportionment. That court's reference to such ownership is in a portion of

(Continued on following page)

potentially relevant should be excluded, as a matter of law, from the universe of facts which a trier of fact has available to it. Moreover, the relevance of facts may become more obvious when they are considered in the aggregate. As this Court has put it:

> We need not decide whether any one of these factors would be sufficient as a constitutional matter to prove the existence of a unitary business. *Taken in combination*, at least, they clearly demonstrate that the state court reached a conclusion "within the realm of permissible judgment."

Container, 463 U.S. at 179-180; footnote del.; emphasis added.

Indeed, Mead's contention that statements in its annual report bear no relation to the existence of an operational function (Pet. Brief, pp. 17 and 37) overlooks the fact that such statements have been viewed by this Court as relevant evidence in other cases. In *Mobil Oil*, for example, this Court relied on the content of the taxpayer's corporate reports as evidence of the fact that the taxpayer's subsidiaries and affiliates were part of its integrated enterprise. *Mobil Oil*, 445 U.S. at 435. In *Container*, as well, this Court

---

its opinion where it is distinguishing the instant case from a different case. *Mead Corp. v. Department of Revenue*, 371 Ill. App. 3d 108, 118 (2007). In addition, as this Court has made clear, apportionment can be justified even in the case of minority ownership, depending on the circumstances. *Mobil Oil*, 445 U.S. at 430.

relied on the evidentiary support provided by the taxpayer's Annual Report. *Container*, 463 U.S. at 180, n. 19.

The rules of evidence do not change simply because of the nature of the fact that one seeks to prove. Statements in an annual report are statements of the company that prepared it, as are other documents, such as Forms 10-K, which are filed with the Securities and Exchange Commission, and the state tax returns filed by the taxpayer. Whether such statements are relevant in the context of a specific case, and what weight should be given to them, should be left to the sound discretion of the trier of fact.

Likewise, contributing capital support for the purpose of developing an asset may be relevant to the determination of an operational function in the context of other facts that show that an asset was being developed so as to be used to help the taxpayer generate apportionable income. *See, e.g., Container*, 463 U.S. at 180, n. 19. For the same reason, the fact that a parent company approves major capital expenditures, or manipulates the structure of the business enterprise, such as through merging a subsidiary into the parent corporation, could be relevant.

Indeed, the fact that Mead merged Lexis into the parent corporation in 1993 appears, from the evidence, to have been for the purpose of reducing

Mead's apportionable income for state tax purposes.[3] This conclusion is supported by the following portions of Exhibits 35 and 37, which constitute statements, and therefore admissions, by Mead:

> It has been determined by Mead's Tax Department that a merger of Mead Data Central into Mead Corporation would result in substantial *state tax* savings. Estimated annual savings range from $1.2 million for 1994 increasing to $2.5 million by 2007 (based on current projections). The savings will occur primarily because Mead will be able to utilize net operating loss carryforwards which might otherwise expire unused.

(Exhibit 35; Joint Appendix, p. 147; emphasis added.)

---

[3] Mead's actions might also be relevant for purposes of the "duty of consistency" doctrine. This Court has long held that general principles of estoppel apply to tax cases. *Stearns Co. v. United States*, 291 U.S. 54, 61-62 (1934) ["[N]o one shall be permitted to found any claim upon his own inequity or take advantage of his own wrong."]; *Magee v. United States*, 282 U.S. 432, 434 (1931) ["The taxpayer benefited by the claim and is not in a position to contest its legality."]. Simply stated, the duty of consistency prevents a taxpayer from taking one position on its tax return in one year, and a contrary position in a later year, after the statute of limitations has expired in the first year, to reduce its taxes in both years. Assuming Mead's strategy, of making Lexis into a division so it would be treated as unitary, succeeded in reducing its state taxes for one year, it would be inequitable to allow it to change its position in a subsequent year to reduce its taxes in that year.

CURRENT SITUATION

Mead Data Central Inc. and Mead Digital Systems, Inc. both operate as wholly-owned subsidiaries of Mead. Due to the stage of market development, the nature of their business, and similar matters; these two business units are not currently as profitable in relation to sales, assets employed and payroll as other segments of Mead. As separate corporations they pay state income taxes based on their *separate* corporate results. For U.S. income tax purposes, they are included in Mead's consolidated U.S. income tax return.

PROPOSED CHANGE

It is proposed that Mead Data Central Inc. and Mead Digital Systems, Inc. be liquidated/merged into Mead and be operated as separate divisions. As divisions of Mead, the financial results of their operations, *consolidated with the rest of Mead*, would result in a projected combined net *state income tax savings* of $3.0 to $5.0 million over the next five years.

(Exhibit 37; Joint Appendix, p. 149; emphasis added.)

Thus, according to the evidence, the merger allowed Mead to utilize net operating losses generated by one entity, which would otherwise have gone unused, by setting them off against the gains of another. Since the evidence shows that Mead's expectation was that the merger, and the use of the net

operating losses, would result in savings in state income taxes, one can reasonably draw the inference that the savings would be in the state income taxes imposed on Mead's apportionable income. Those savings, in turn, would obviously increase Mead's after-tax net profits. This increase would not have been just an increase in Mead's after-tax net income. The savings would have increased Mead's after-tax net *apportionable* income, thus providing a benefit to Mead's multi-state business operations.

Moreover, the impact on Mead's apportionable income was expected to be on-going. Thus, Mead's decision to merge Lexis into Mead resulted, or at least was expected to result in, an ongoing reduction in Mead's after tax apportionable income. To borrow this Court's language, the merger was not an "arm's length" transaction, and "the resulting flow of value is obvious." *Container*, 463 U.S. at 180, n. 19.

The evidence surrounding the purpose and nature of the merger is not only relevant in its own right. It also illustrates how other factors – in this case the manipulation of Mead's business structure – can be seen as relevant when they are viewed as part of the evidentiary background of a case. Consequently, this Court should reject Mead's effort to create categorical restrictions on what a trier of fact can consider.

IV. The Court Should Reject Mead's Implied Suggestion That The Burden Of Proof Should Be Shifted To The Tax Agency

In its brief Mead suggests that the State, rather than the taxpayer, bears the burden of proof, stating "assuming it were enough that the nonunitary asset served an operational function *even if* its sale did not (something this Court has never before endorsed), Illinois still could not satisfy that standard to justify taxing the sale." (Pet. Brief, p. 32; original emphasis.) Mead also states: "Illinois maintains that a putative taxing State has no obligation to show that 'the asset was utilized directly in the selling company's business.'" (Pet. Brief, p. 45.) Mead's effort to shift the burden of proof to the State is contrary to sensible and well-settled law.

This Court's precedents make it unmistakably clear that the burden of proof in apportionment cases is on the taxpayer. The taxpayer "has the burden of proof; it must demonstrate that there is 'no rational relationship between the income attributed to the State and the intrastate values of the enterprise.'" *Container*, 463 U.S. at 180; *see also*, *Mobil Oil*, 445 U.S. at 442, n. 16. This Court also explained that "[t]his burden is never met merely by showing a fair difference of opinion which as an original matter might be decided differently." *Container*, 463 U.S. at 176, quoting from *Norton Co. v. Department of Revenue*, 340 U.S. 534 (1951).

The imposition of the burden of proof on the taxpayer makes sense. It is the taxpayer who has control over the records and other information that reveal the nature of the taxpayer's business. The taxpayer can easily produce the documents and facts necessary to establish whether the various business segments under consideration operate as a single economic enterprise.

When a taxpayer files its return on a unitary basis, or stipulates to the ultimate fact that it is engaged in a unitary business, the State necessarily relies on that representation, and consequently does not pursue an audit of the underlying proposition (whether the taxpayer is engaged in a unitary business). The States' resources are limited and therefore States must be able to rely on a taxpayer's filing position, particularly so if the filing position is consistent for numerous years. Otherwise, States would be obligated to audit every issue for every year without regard to whether an issue is even in dispute.[4] This would be inefficient and unfair to state tax authorities, and would impose an unwelcome and intolerable burden on taxpayers, as well.

---

[4] This point is illustrated by Mead's 1993 Illinois tax return. Mead filed on a unitary basis with Lexis/Nexis, as it had done since 1988, and derived whatever benefit arose from that position. Mead should be bound by its duty to consistently report the manner of treatment of items of income and expense, not only from year-to-year, but within the same year as well.

Assigning to the taxpayer the burden of proof is particularly justified in apportionment cases. As this Court has recognized, in the case of multi-state business enterprises, "arriving at precise territorial allocations of 'value' is often an elusive goal." *Container*, 463 U.S. at 164. For that reason, this Court has held that, "the taxpayer has the 'distinct burden of showing by clear and cogent evidence that [the state tax] results in extraterritorial values being taxed. . . .'" *Id.*

For years, state courts, taxing agencies, and taxpayers have relied on the fact that the burden of proof is assigned to taxpayers. For the reasons discussed above, an alteration of the burden of proof would be immeasurably disruptive.

V. Illinois Properly Determined That The Income Was Apportionable

When a component of an interstate business enterprise enhances that business' net after-tax *apportionable* income, there is a flow or transfer of value that evidences the "minimal connection" and "rational relationship" required by the Constitution, whether the component is viewed as being engaged in a "unitary relationship" or as serving an "operational function." In such a case, apportionment of the income generated by that component is properly apportioned along with the rest of the apportionable multistate income of the enterprise. A taxpayer challenging such apportionment has the burden to

prove that the "minimal connection" and "rational relationship" do not exist.

Here, the taxpayer did not meet its burden to show the absence of a minimal connection and rational relation between the activities of Mead and Lexis. In fact, such connections existed. The merger of Lexis into Mead was done for the purpose of setting off against the gains of one part of the business the losses incurred by another part, with the result that Mead expected an ongoing savings in its state income tax burden caused by the reduction in the amount of its apportionable income that would have been taxed. The expected decrease in that burden would have caused an increase in Mead's net after-tax apportionable income. Thus, there would indisputably have been a "flow of value" between Lexis and Mead. Lexis constituted an asset that was part of the unitary business of Mead, and upon its sale the gain from that sale was properly apportioned.

In addition, Mead incorrectly suggests that there was no operational function performed by Lexis because "the *sale* of Lexis/Nexis – i.e., the capital transaction Illinois seeks to tax – did not serve any operational function to Mead." (Pet. Brief, p. 32; original emphasis.) However, it is not the *sale* that indicates whether Lexis performed an operational function; it is how Lexis was operated and used while it was owned which matters.

The trial court and the Illinois appellate court concluded that the gain from the sale of Lexis was apportionable based on the evidence that, taken in

combination, demonstrates that the constitutional requirements are met. That conclusion is consistent with this Court's precedents, and should be affirmed.

CONCLUSION

For the reasons set forth above, amici curiae respectfully request that the Court affirm the Illinois appellate court's decision below.

Dated: December 7, 2007

Respectfully submitted,

EDMUND G. BROWN JR.
Attorney General of the
State of California
MANUEL M. MEDEROS
State Solicitor General
DAVID CHANEY
Chief Assistant Attorney General
PAUL GIFFORD
Senior Assistant Attorney General
GORDON BURNS
Deputy Solicitor General
ANNE MICHELLE BURR
Deputy Attorney General
GEORGE SPANOS
Deputy Attorney General
Counsel of Record
1300 I Street
Sacramento, California 94244-2550
Telephone: (415) 703-1403
Fax: (415) 703-5480
Counsel for Amici Curiae